VZCZCXRO2286
PP RUEHCN RUEHGH RUEHVC
DE RUEHBJ #4074/01 3020925
ZNR UUUUU ZZH
P 280925Z OCT 08 ZDS
FM AMEMBASSY BEIJING
TO RUEHC/SECSTATE WASHDC PRIORITY 0644
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
INFO RUEHOO/CHINA POSTS COLLECTIVE
RHEHNSC/NSC WASHDC

UNCLAS SECTION 01 OF 04 BEIJING 004074

C O R R E C T E D C O P Y// DELETE TEXT IN PARENTHESES //
//IN THE FIRST SENTENCE PARA 4//

SIPDIS
SENSITIVE

FOR EAP/CM/PARK AND E/YON
TREASURY FOR OASIA/DOHNER/WINSHIP
NSC FOR SHRIER/LOI

E.O. 12958: N/A
TAGS: ECON EFIN CH
SUBJECT: OCTOBER 19-20 VISIT OF TREASURY U/S MCCORMICK TO BEIJING

BEIJING 00004074 001.2 OF 004

THIS CABLE IS SENSITIVE BUT UNCLASSIFIED. NOT FOR INTERNET DISTRIBUTION.

¶1. (SBU) Summary. Vice Premier Wang Qishan and other senior Chinese financial officials told U/S McCormick on October 20 that China welcomed recent U.S. Government actions to address the financial crisis. People's Bank of China Governor Zhou Xiaochuan and other officials raised questions about the continuity of U.S. policies into the next administration. Zhou noted that some senior Chinese leaders are not fully aware of the extent of USG guarantees of U.S. banks' liabilities and commitment on Fannie and Freddie debt. Interlocutors stressed that unless leaders' concerns about the viability of banks and U.S. government-sponsored enterprises (GSEs) are assuaged, lower level officials will be constrained from taking on greater counter-party risks or extending the maturity of the Chinese government's GSE holdings. Zhou emphasized that, while the pace of RMB appreciation might slow periodically due to China's domestic factors, the decisions about its medium-term path have been made and the U.S. "should not worry." Interlocutors said that while Chinese leaders and businessmen welcome the message that the U.S. is open to Chinese investment (including in the financial sector), they remain cautious, having suffered large financial and political setbacks from U.S. investments, including in Blackstone and the Reserve Fund. End Summary.

¶2. (SBU) During his October 19-20 visit to Beijing, Treasury U/S David McCormick briefed Vice Premier Wang Qishan and senior officials at the Ministry of Finance (MOF), People's Bank of China (PBOC), China Banking Regulatory Commission (CBRC), and China Securities Regulatory Commission (CSRC), as well as leaders of the China International Capital Corporation (CICC) and China Investment Corporation (CIC), on the four-part U.S. policy approach to stabilizing the markets and economy: 1) the Federal Reserve's purchase of commercial paper to inject liquidity; 2) the Securities and Exchange Commission's actions to safeguard market integrity and prevent market manipulation (including through limits on short-selling); 3) the Federal Deposit Insurance Corporation's guarantee of banks' short and medium-term liabilities (including non-interest bearing accounts) in order to assuage concerns about counter-party risks; and 4) Treasury's pledge to

inject $700 billion into the U.S. banking sector, either through increased capital or purchases of impaired assets. In each meeting, U/S McCormick also emphasized that even though the U.S. government did not explicitly guarantee GSE debt, it effectively did so by committing to inject up to $100 billion of equity in each institutions to avoid insolvency and that this contractual commitment would remain for the life of these institutions. He also stressed importance of the next session of the Strategic Economic Dialogue (SED), and in particular the importance of having tangible results, as both financial markets and the next administration will be watching and assessing the SED's merits.

Vice Premier Wang Qishan

¶3. (SBU) Vice Premier Wang welcomed recent U.S. Government actions, saying they had addressed liquidity problems but had not solved equity market nor distressed debt problems. He speculated that the United States will have to recapitalize lenders, and expressed concern that the Fed's liquidity injects could lead to inflation if the US economy recovers next year. Wang emphasized that China's leaders, including President Hu Jintao and Premier Wen Jiabao, do not want to see problems in the U.S. economy. (Comment: Wang was likely responding to articles in the Chinese press and on the web that had initially welcomed the financial disorder as the demise of U.S. economic "hegemony." End comment.) U/S McCormick assured Wang that it would require an unprecedented act of Congress to renege on the contracts made to guarantee Fannie Mae and Freddie Mac debt. He also explained that Chinese investment in financial services companies would be welcomed, and the Federal Reserve would be responsible for approving investments in banks and bank holding companies.

¶4. (SBU) The Vice Premier praised Secretary Paulson's use of the Strategic Economic Dialogue (SED) mechanisms to coordinate with China throughout the crisis. Wang stated that the Chinese government attaches great importance to the SED, and both Hu and Wen had spoken positively of the forum's form and substance. Wang noted that in the U.S. media, some observers had focused on the need for the SED to deliver concrete results, while others -- including Senator Obama in a recent interview -- had emphasized the strategic economic relationship. Wang agreed with U/S McCormick that the SED needed to cover both tactics and strategy.

People's Bank of China

¶5. (SBU) PBOC Governor Zhou Xiaochuan inquired about the continuity of U.S. policies during the transition to the next U.S. administration. On US agency debt, Zhou understood that the USG stands behind Fannie and Freddie debt fully, but believed that senior leaders as well as lower-level bank officers were not fully cognizant given that the USG did not explicitly guarantee the debt and uncertainly remains about the GSE's long-term structure and roles. Similarly, Zhou agreed that depreciation of the RMB against either the USD or on a trade weighted basis at a time when demand in its major trading partners is weakening could be politically sensitive for China's trading partners, but added that this issue was not simple for China's top leadership. Zhou said he believes it remains important that prices signals from a more appreciated exchange rate promote a reduction in China's domestic and external imbalances, but the State Council felt pressure to signal support for the export sector by limiting appreciation the RMB. Given the expected sharp decline in external demand, Zhou said he did not think it useful or effective to try to

promote exports by holding down the price of Chinese exports through the exchange rate, but that it was difficult to get a policy consensus for this. Zhou added that periodic pauses in the pace of RMB appreciation should not be a concern to the U.S. as long as the long-term trajectory remained the same. On Chinese investment in the U.S., Zhou said some Chinese political and business leaders appreciate the U.S. open investment message, but remain cautious after the losses suffered on investments to date, including Blackstone and the Reserve Fund investment by CIC. Despite encouraging rhetoric from senior USG officials, they also doubt that the regulatory and political climate is open to Chinese investment, including CFIUS.

¶6. (SBU) Zhou expressed appreciation for U.S. assistance in China gaining membership in the IDB, as well as for the granting of a bank branch license to ICBC. He added that neither issue was of particular importance to the PBOC itself, but that they had to pursue them vigorously on behalf of other constituencies, notably MOFCOM for the IDB. More generally, Zhou noted his appreciation for the ongoing close communication with Treasury. He added that, after the Lehman Brothers' bankruptcy, Chinese banks remained nervous about counter-party risk in dealing with foreign banks. He assured McCormick that the PBC would take steps to ensure foreign banks have access to liquidity, which was why the PBOC had decided recently to raise, on a temporary and exceptional basis, the foreign banks' foreign currency debt quota to allow them to access financing from their overseas parents. Zhou said PBOC is also considering establishing a liquidity facility for banks similar to the one adopted by the Hong Kong Monetary Authority.

Ministry of Finance

¶7. (SBU) Minister of Finance Xie Xuren told U/S McCormick that China viewed a sound U.S. economy as in the best interest of the world economy, and that both President Hu Jintao and Premier Wen Jiabao placed great importance on international cooperation to resolve the financial crisis. For the upcoming SED, Xie said he hoped the December session would include discussions on the lessons of the financial crisis and how to limit financial turmoil in the future. He suggested that China and the U.S. should discuss how to increase market liquidity and confidence along with financial supervision and how

to balance best financial innovation with financial regulation.

China Banking Regulatory Commission

¶8. (SBU) CBRC Chairman Liu Mingkang responded favorably to recent USG actions. He also expressed interest in continuing close cooperation with the U.S., and emphasized the need for global coordination. Looking ahead, Liu commented that hedge funds and private equity may by "the next shoes to drop" and said China would take further stimulatory measures to guard against economic risks. Liu noted the need to delegate more loan decision-making authority to local bank managers, and to provide more financing to small and medium enterprises. Liu also advocated support for housing markets through more favorable loan terms (Comment: the government recently reduced down payments for first time buyers of small apartments). He said the decline in global energy prices would give China an opportunity to lift price controls. Finally, Liu asked for the Chinese government to be informed before U.S. strategic investors dump their shares in Chinese banks, when the lock-up period ends.

China Securities Regulatory Commission

¶9. (SBU) CSRC Vice Chairman Yao Gang said the CSRC is working with the New York Stock Exchange to resolve legal issues and enable foreign firms to issue depository receipts in Chinese markets. For credit rating agencies, Yao said CSRC would accept license applications from joint venture companies after the SEC issues revised regulations covering their operations as agreed to at SED IV. Finally, Yao confirmed that the CSRC report on foreign involvement in China's capital markets would be completed by the end of the year.

China International Capital Corporation

¶10. (SBU) CICC CEO Levin Zhu observed that China's "over-built" export sector would be severely impacted by any recession in the U.S. CIIC Chief Economist Ha Jiming said China's unemployment rate, currently about six percent, would rise over the next two years and reduce consumption growth. He believed China's economy would "slow significantly." Export growth would fall due to three factors: the exchange rate, declining external demand, and the credit crunch; regarding the latter, Ha said the PBOC was instructing Chinese banks to lend to exporters, but the banks were increasingly unwilling to do so given concerns about exporters' prospects. As a result, he believed real GDP growth would decline to about seven percent in 2009, absent any significant policy adjustments. Ha also believed the government's ability to respond with a stimulus package, which CEO Zhu opined was probable, would be limited due to sharply decelerating revenue growth. The "good news," said Ha, was that the government has the capacity to undertake fiscal stimulus without raising concerns about fiscal sustainability as public debt is very low as a percent of GDP.

¶11. (SBU) Ha believed there would be "lots of political pressure" if the RMB continued to appreciate against the USD, while the USD appreciated against the Euro and the currencies of China's other major trading partners; furthermore, the EU was not taking pre-emptive actions and faced a much larger housing bubble than the U.S. As a result, he viewed the euro as "shaky." Overall, Ha concluded that the financial crisis would cause China to become more cautious regarding financial sector reform.

China Investment Corporation

¶12. (SBU) China Investment Corporation (CIC) General Manager Gao Xiqing said CIC had been preparing daily reports to the State Council, along with other Chinese agencies on its exposure to potential losses on overseas investments. Gao stressed that it would be problematic if it was viewed in China that the USG offered preferential treatment to certain countries and/or companies, such as Japan and Mitsubishi's investment in Morgan Stanley. U/S McCormick assured Gao that the guidelines applied to CIC and China would be consistent with those for other

investors, and noted that the U.S. Treasury's equity injection in Morgan Stanley had protected CIC's stake by having an equal, and not senior, claim. McCormick urged CIC to consider and consult with the USG on potential investments in the U.S. financial sector. Gao indicated that CIC now was comfortable with the situation of its U.S. money market investments, and said they currently did not own any Fannie Mae/Freddie Mac debt but were considering purchases. CIC, while more confident now, still retained concerns about continuation of the USG's new policies and programs under the next administration. CIC also was concerned about the impact of the financial crisis on the real economy, which they believe will slow further and cause a "bumpy ride" for stock markets. They also questioned the inflationary impact of issuance of large

volumes of treasuries. Finally, Gao noted that one reason CIC tries to avoid CFIUS is that the CIC board of directors (vice ministers of various government agencies) have concerns about having to report personal information to CFIUS.

Comment

¶13. (SBU) All of U/S McCormick's counterparts appeared to appreciate his willingness to come to Beijing in the midst of a financial crisis. Securities regulators subsequently told FINATT that the State Council financial crisis working group under Vice Premier Wang Qishan subsequently met to discuss McCormick's visit. The overarching message from his interlocutors is that the Chinese government wants to play a constructive role (and at the very least does not want to do anything destabilizing) as financial and economic weakness in the U.S. have financial, economic and political costs in China and to its leaders. Technocrats stressed the importance of explaining the policy implications of USG actions to assuage senior leaders' and State Councilors' concerns about the durability of U.S. policy responses into the new administration. This highlights the importance of not only engaging with Vice Premier Wang, but also other economic ministries such as Finance, which report to other Vice Premiers. On the SED, the relevant Chinese agencies reconfirmed the usefulness of the SED, and also their strong interest in and support for a successful SED session in December.

PICCUTA